Briefing for Long-run
Aggregates FOMC meeting
of 2/6/79
S. H. Axilrod

As background to the discussion of the longer-run ranges, it might first be useful to review briefly recent trends in the aggregates and their relationship to the ranges the Committee has been setting: Ranges for the year just past--QIV '77-QIV '78--were 4 to 6-1/2 per cent for M-1, 6-1/2 to 9 per cent for M-2, and 7-1/2 to 10 per cent for M-3. These ranges were set last February and were held essentially unchanged in the course of the year--except for the adjustment made in October for the ATS effects on M-1. For that period, QIV '77-QIV '78, M-1 came in above the range again, but less so than it had in the previous year. It grew at a rate of 7.3 per cent; without ATS effects that rate would have been 7.5 per cent. M-2 and M-3 were well within the ranges set by the Committee, at 8.5 and 9.4 per cent, respectively.

The interesting development is that growth rates of all these aggregates have been veering sharply downwards in the last few months of 1978 and early 1979, and all the aggregates have been growing well below the long-run ranges set by the FOMC. In the 3 months ending January 1979 M-1 growth was -1.8 per cent (+0.5 per cent without ATS effects); M-2 growth was about 2 per cent and M-3 growth around 5.4 per cent. M-1+ declined 4.6 per cent--such a rapid rate of decline it sort of just drifted out of the blue book in the process.

Three reasons might be advanced for the sharp downward veer in these growth rates. The first and very usual reason is that the cumulative impact of the 2-1/2 percentage point rise in short rates since mid-year is affecting the aggregates with the usual lag. That would not, of course, cause the "veer" but it would cause some decline in growth from what it had been before. More particularly, I should point out that the strength in spending in the last few months has been reflected, I believe, in an increased willingness of the public temporarily to draw down their liquidity. Now this may sound somewhat hypothetical, but if one looks back over the past several years in the quarters in which there was sharp growth in real GNP--that is, a growth in real GNP sharper than the surrounding quarters, irrespective of trend (QIV '78, QII '78, QI '77, QI '76, and QIII '75)--velocity of M-1 was considerably higher than in the surrounding quarters. For example, in the third quarter of 1978 even though M-1 growth was sharp M-1 velocity was about 9.1 per cent. Finally, the reassessment by the public of portfolio positions, especially their transactions and precautionary balances following the ATS innovation, and the realization that interest rates and inflation may be at high levels for a sustained period, has undoubtedly caused people to shift money out of demand and savings deposits into instruments other than ATS accounts--including money market funds, which as noted in the blue book have grown very sharply in the past 2 months, and other similar instruments.

The staff expects growth in M-1 to resume over the year ahead as the usual lagged effects of interest rate increases wear out and as the public attempts to restore balances depleted by the recent surge in spending. The evidence I pointed out earlier shows that these velocity increases aren't sustained; velocity returns to more normal levels. The staff does expect the underlying growth rate of M-1--apart from ATS effects--to be slower in 1979 than over the past two years for two reasons: the slower nominal GNP growth, and our assumption of a downward shift in demand for M-1 of about two percentage points (again apart from ATS effects). Such a downward shift has been assumed to occur when interest rates moved to high ground, and that has been built into our forecast of the interest rate-money relationship for about the past year, and was essentially the reason why we did not forecast higher Federal funds rates other than the 9-1/2 to 10 per cent range at the Committee's target level. Whether our luck will continue in this, I don't know, but thus far it has.

If such a shift does not develop, higher interest rates would be needed to restrain M-1 growth if the Committee wanted to stay with that particular M-1 target rate. Or to put it the other way, more growth in M-1 would be needed, given current interest rates. On the other hand--and this is also a possibility--a greater shift may develop. In the first quarter we have evidence of a greater shift; we just don't believe that that will be sustained. If a greater downward shift develops the Committee would need to permit lower M-1 growth for any given interest rate level.

The staff also expects a pick-up in growth of M-2 and M-3 as the year progresses, as the shift out of time and savings deposits of highly interest-sensitive funds abates. But, still, recent experience suggests that the public is likely to remain quite interest sensitive. Thus, growth in broader aggregates, too, is likely to be much slower in 1979 than in the last two years. That is the reason for the lower ranges of broader aggregates in the blue book alternatives.

The Committee's decision today is probably essentially whether to lower the aggregates ranges or to leave them unchanged. There is some difference from recent Committee decisions in this regard in that account needs to be taken of the Administration's short-run goals and the relationship of the Committee's ranges for the aggregates to these goals--that is, under the procedures set forth in the Humphrey-Hawkins Act, that relationship has to be explained, at least.

There are some arguments, of course, for lowering the ranges and I would like to present a few to the Committee for consideration. First, a step needs to be taken that will move in the direction of reducing the rate of inflation over the long run. It has been a year, as I mentioned earlier, since any range has been lowered. Meanwhile, inflation and the public's perception of inflation have worsened. With regard to the broader aggregates, a lowering of the ranges would be consistent with the apparent recent downward shift in the demand for them, and if the ranges aren't lowered, there is a great danger that actual growth will be below the ranges set by the Committee. Finally, lower ranges may, over the near term, enhance confidence that the slowing of price inflation can be achieved in 1979 and thus will help increase the odds that the Administration's anti-inflationary program will succeed.

There are also, of course, reasons for not lowering the ranges, or for lowering them with caution. With regard to M-1, the earlier range had been unrealistic; events seem to be making it realistic, though barely so, and with the requirement that we continue to have considerable luck. So the Committee may achieve more credibility by leaving the range unchanged and letting actual growth come within it than by lowering the range and still missing actual growth. Secondly, the broader aggregates are highly sensitive to interest rate fluctuations, so that if there's any thought that interest rates might decline substantially over next year--say a couple of percentage points or so--the Committee might want to leave room for some greater growth in these aggregates than the staff has projected. And as a third point I should add that if sharp reductions are made in the M-2 and M-3 ranges even if they are correct, they might be perceived publicly as an advertisement of a crunch and have unfortunate psychological repercussions.

Balancing these various arguments I would make the following recommendations for Committee consideration: With regard to M-1, one might consider lowering the present 2 to 6 per cent range to 2 to 5 per cent, and construe the midpoint, rather than the upper point, as the basic assumption. I think this would get reporting under the Humphrey-Hawkins Act off on a more reasonable and less awkward basis. Such a range would leave ample room for changing economic circumstances within the year. It would be a range I believe that is more realistic and more likely to be hit. And finally, I would point out that this would narrow the width of the range from its present 4 points to 3, but the 3 is a little bit wider than usual. I believe, however, that the three points are needed because of the continuing uncertainty about ATS. Implicit in such a range would be a deceleration of M-1 associated with ATS of around 3 percentage points. Second, I would suggest lowering the ranges for M-2 and M-3 but not quite by the dimensions indicated in the blue book. The Committee may wish to leave room over the full year ahead for the possible effect of significant interest rate declines, should they develop, or for other adjustments such as Regulation Q ceiling rates. Moreover, the Committee might wish to avoid giving the impression of a potential credit crunch by publication of sharply lower ranges.

Thus, I would suggest for the Committee's consideration a range for M-2 of 6 to 8-1/2 per cent and for M-3, 7 to 9-1/2 per cent--1/2 point lower than at present on both ends. If a wider range were practical in terms of public relations, it would probably be desirable to put a 1/2 point further reduction on the bottom ends of those ranges--that is, 5-1/2 to 8-1/2 per cent for M-2 and 6-1/2 to 9-1/2 per cent for M-3. That would increase the odds that growth would be within those ranges; but I think in terms of public relations it might be best to stay with the somewhat narrower ranges suggested first.

Briefing for short-run
operating decision FOMC of
2/6/79
S. H. Axilrod

Basic to the alternatives the staff has presented in the Bluebook is an expectation of a very considerable rebound of growth in the aggregates--particularly M-1 and thus reflected in M-2 and M-3--in February and March. Often at the time of the Committee meeting we have some data for the month in which the Committee meeting is held and have some statistical basis for speculation. We have none at this meeting, of course, with no evidence at all about February. Our expectation is based on the fact that if we don't have a very sizable rebound, we're not even going to have a positive rate of growth for M-1 for the first quarter on average, and we're going to have a velocity far larger than we think is explainable, or sustainable--given the projection of about a 13 per cent increase in nominal GNP. Thus we really do believe that we will have a rebound in February and March; a 7 per cent rate of growth, which is the center of the various alternatives, is what we projected. If you put the ATS effects back in, in effect that's a 10 per cent rate of growth on average for the 2 months which means we're going to have to have a very big month--that one of those months is probably going to be very large.

Now I would like to call the Committee's attention again to the table on page 14 which we put in the Bluebook in response to the discussion of the subcommittee report last time and also in response to other requests that we relate the short-run alternatives more specifically to the long-run alternatives. Based on the midpoint of the 1-1/2 to 4-1/2 per cent range for M-1 shown under alternative B, that table shows that from January you would have to have growth in M-1 of 5.3 per cent and in M-2 of 7.8 per cent, to reach the low end of the range by March. And the range is defined as the cone based on the fourth quarter of 1978. So a sharp rebound in the coming 2 months would be consistent with moving back into the range that the Committee has just adopted in view of the shortfalls that have been experienced already.

It's of course quite possible that the aggregates will remain unexpectedly weak in the first quarter if the shift out of money into other competing assets is even stronger than we have allowed for. In the first quarter, we've allowed for a shift not of 2 per cent but of 3-1/2 per cent in addition to the ATS. So our first-quarter allowance is much larger than we're expecting for the year as a whole. At the same time, of course, you could get even more strength than we've projected if the economy is quite a lot stronger than the staff projection or if this shift doesn't develop.

I think the Committee may wish to consider whether it's more important at this particular time--in the 6 weeks ahead--to guard against an excessive rebound in the aggregates or against continued weakness. The inflation problem would tend to argue for guarding against an excessive rebound and permitting some continued weakness in the aggregates for a little while more or at least until signs of weakness in economic activity are much clearer.

We have proposed an optional directive paragraph structured with a proviso clause that would stress money market conditions and suggest no easing at all. It provides an option for tightening if the aggregates are running high, but no option for easing if the aggregates are running weak. You could have the same effect without using that optional paragraph by using the language adopted at the last meeting which would permit some tightening if the aggregates were running strong but would limit the easing to the point where the aggregates are running very weak--that is, the tightening would occur if you're moving above the midpoint of whatever ranges are adopted by the Committee but the easing would not occur until you reach the bottom of the ranges. That may be a more preferable approach at this time since the Committee has already had 3 months of weakness and it may not wish to have 2 more months without taking any action. Thus, the operational point becomes what ranges should be adopted both for the money market conditions and the aggregates if you want to have such an asymmetrical approach.

Therefore, Mr. Chairman, I would say that the Committee probably might want to consider permitting a pretty sharp increase in M-2 in view of the weakness that we've had and the strains that's putting on credit conditions at banks and at thrifts. From that point of view, the alternative 2 range of 5 to 9 per cent for M-2 may be quite desirable. An M-1 range somewhat lower than the associated 4-1/2 to 9-1/2 per cent might be considered if the Committee wants to respond more promptly to a rise in the monetary aggregates. As for the Federal funds rate, since there has been no change in that rate since the last meeting, a range such as that in alternative 2 still permits the degree of tightening or easing that the Committee was willing to contemplate at the last meeting and I don't think conditions have changed such as to require an adjustment in that range.

Alan R. Holmes
Notes For Meeting Of
FOMC February 6, 1979

Scott has already reported on our substantial progress in repaying swap debt. Since year-end, we have paid off Net no less than $ 1.1 billion of our Deutsche mark debt, bringing it $ 591 million below the level outstanding at the December Committee meeting. We have made steady progress on our repayment of current Swiss franc swap debt bringing the total outstanding down to the equivalent of $ 423 million a reduction of $ 344 million from the level outstanding at the last Committee meeting. And, of course, we have completely paid off our Japanese yen swap debt. I should note that repayment of yen debt resulted in a profit of $8.5 million, of which the System gets half. To date, repayment of current Swiss franc swap debt has resulted in a profit of $36million, shared equally with the Swiss National Bank. We have of course suffered substantial losses in our operation in Deutsch marks. As of today, our losses total $ 71 million, equally shared with the Bundesbank. Should we able to acquire DM at current rates to repay our outstanding debt of $ 3.4 billion, we would cut those losses by almost $ 27 million.

As for our current situation, the System has about 41.7 billion in DM swaps maturing before the end of March that are not covered by previous committee decisions. All of these are fist renewals and I recommend that they be rolled over on maturity, if that should prove necessary.

As far as out Swiss franc position is concerned, we have ten swaps totaling about $350 million maturing before the end of March that are not already covered by a Committee decision. I recommend that, if necessary, these swaps be renewed. They are all first renewals. I should note that we acquired this morning $107 million in Swiss Planes directly from the Swiss National Bank for debt repayment.

As already noted, we have repaid our yen swap debt, and have accumulated about $50 million in yen over the past few days as the dollar appreciated sharply against the yen. That acquisition was in the New York market.

This acquisition, together with possibility that intervention in the market may from time to time be required to prevent too rapid appreciation of the dollar, raises the question of the System's position with respect to the acquisition of foreign exchange assets. In my view the System would be wise to acquire a substantial amount of foreign currency under appropriate market conditions, giving us ammunition to defend the dollar later on if necessary and avoiding exclusive reliance on the swap network. This is a matter that needs solid study of the exchange risks involved, the appropriate size and composition of a foreign currency asset portfolio, and of Federal Reserve – Treasury relations in this area. We are preparing a memorandum on this subject. We plan to have it ready in time for Board staff review and submission to the Committee well before the next meeting.

Meantime, however, I believe the System should be prepared to acquire yen and Swiss francs should we be able to pay off our current Swiss franc swap debt before the next Committee meeting. Acquisitions would be made only if market conditions so dictate and with the full concurrence of the Treasury and the foreign central banks concerned. I would suggest that we not exceed $500 million, with the probability that the amount may be substantially less. Acquisition of Deutsche marks—except temporarily pending repayment of swap debt—would not seem likely for some time to come.

As I understand, the Committee has not established a formal limit on the amount of foreign exchange that can be acquired or held. Hood lings would be subject to the general limitations of the Committee's limit on the System's overall open position, but that is not much of a limitation at the moment. At the Desk, however, we have always felt constrained by the Committee discussions of foreign exchange holdings way back at its December 1975 meeting. At that meeting, I proposed, and the Committee concurred, that we try to build up our foreign exchange holdings to $150 million, with the expectation that the Committee would review the situation should we reach that amount. In the event we never reached even that modest target, given the general pressure on the dollar that existed over much of the period.

Last week, however, as we began to acquire yen—acquisition that seemed reasonable and desirable, and informally assented to by members of the System's foreign exchange subcommittee and the Treasury—it appeared that we might approach the $150 million figure by the time of this meeting. He we done so, I would have felt obliged to put the matter before the Committee. On Friday, however the Bank of Japan decided to take all of our yen purchases in New York for their own account, so that our yen holdings held steady at just under $50 million. Other holdings, apart from Deutsche marks and Swiss francs which are earmarked to repay debt, amount to only $13million equivalent at the moment.

It is my understanding that no formal vote is needed on the suggestions that the informal limit on the foreign currency acquisition be raised from $150 million to $500 million if the Committee is in general agreement. I would, however, like to have the Committee's views. The larger amount may be needed to meet System commitments in the foreign exchange market and, I hope, can be reviewed in depth at the next Committee meeting.